UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

San Diego Gas & Electric Company, Complainant, v. Sellers of Energy and Ancillary Services Into Markets Operated by the California Independent System Operator and the California Power Exchange, Respondents.	Docket Nos. EL00-95-000 EL00-95-002 EL00-95-003
Investigation of Practices of the California Independent System Operator and the California Power Exchange	Docket Nos. EL00-98-000 EL00-98-002 EL00-98-003
Public Meeting in San Diego, California	Docket No. EL00-107-000
Reliant Energy Power Generation, Inc., Dynegy Power Marketing, Inc., and Southern Energy California, L.L.C., Complainants, v. California Independent System Operator Corporation, Respondent.	Docket No. EL00-97-000
California Electricity Oversight Board, Complainant, v. All Sellers of Energy and Ancillary Services Into the Energy and Ancillary Services Markets Operated by the California Independent System Operator and the California Power Exchange, Respondents.	Docket No. EL00-104-000
California Municipal Utilities Association, Complainant, v. All Jurisdictional Sellers of Energy and Ancillary	Docket No. EL01-1-000

Services Into Markets Operated by the California
Independent System Operator and the
California Power Exchange,
Respondents.

Californians for Renewable Energy, Inc. (CARE),
Complainant,
v.
Independent Energy Producers, Inc., and All Sellers of Energy and Ancillary Services Into Markets Operated by the California Independent System Operator and the California Power Exchange; All Scheduling Coordinators Acting on Behalf of the Above Sellers; California Independent System Operator Corporation; and California Power Exchange Corporation,
Respondents.

Docket No. EL01-2-000

Puget Sound Energy, Inc.,
Complainant,
v.
All Jurisdictional Sellers of Energy and/or Capacity at Wholesale Into Electric Energy and/or Capacity Markets in the Pacific Northwest, Including Parties to the Western Systems Power Pool Agreement,
Respondents.

Docket No. EL01-10-000

(Issued January 4, 2001)

Hoecker, Chairman, concurring :

This opinion is submitted many days after the Commission's Order of December 15, 2000 (December 15 Order). I strongly support that order as a way to stabilize and lower California's extraordinary electricity prices now and to initiate important steps toward ensuring service reliability and reasonable prices for California consumers in the long term. The Commission decided that a facile short-term "fix" could not substitute for a measured set of responses to the complicated and systemic problems associated with the design of California's power market.

The Commission is nevertheless fully aware of the financial pressures that current prices are placing on consumers in California and the West. Our Order and Commissioner Massey, in his concurrence, describe the depth and difficulty of this crisis. None of the answers are easy. Therefore, the December 15 Order in no way relieves the Commission of its responsibility to work assiduously -- through the measures adopted on December 15 and other actions I suggest below -- to return California's markets to a semblance of normalcy and prepare those markets to meet the challenges of the coming summer peak season.

The Western energy shortage has metastasized into a financial crisis of major proportions as well as a crisis of consumer confidence, and events of the last weeks have not altered the fundamental challenge. Here is what has occurred:

- Concerns have intensified about the solvency of California's old line utilities as their retail rates remained capped while wholesale prices remain volatile.

- Secretary of Energy Richardson has issued three emergency orders for Western power generators with excess energy to sell into California to stave off outages. Sales under those orders have comprised a modest but critical share of the total available supply of power.

- In response to high electricity prices in the rest of the West, which jeopardize the finances of utilities in neighboring regions, a number of Western Governors met to consider, among other proposals, the merit of a regional price cap to stem unusual price increases throughout the Western Interconnection. They did not endorse FERC taking that action (at least for now).

- The California Public Utilities Commission began hearings to determine when to eliminate the state's rate freeze and begin passing more of the cost of wholesale power to consumers; how to maintain utilities' ability to provide adequate retail service; whether to authorize additional divestitures of generation facilities; and whether "power produced from retained generation assets should serve native load" and what kind of "ratemaking such actions entail." Yesterday, California approved a temporary retail rate increase.

- Settlement discussions before the Commission's Chief Administrative Law Judge were convened in Washington to develop viable long-term contracts for power for California and diminish reliance on spot market prices, and are ongoing.

- To date, California's major utilities are still selling electricity output and purchasing their requirements through the PX and ISO spot market, contrary to the Commission's Order.

- Continuing pressure on infrastructure is signaled by newly released U.S. census data, which indicate a 13 percent increase in the Nation's population since 1990. The most remarkable growth rates are in the West, including 40 percent in Arizona and 66 percent in Nevada.

I. A Plea For Collaboration

The December 15 Order offers the best opportunity to begin rehabilitating the wounded California power market. It returns the utility-owned resources of Pacific Gas and Electric Company (PG&E) and Southern California Edison (Edison) to state regulation and self-supply. It lays the groundwork for the task of developing an effective market power mitigation plan. It brings market participants to the table to develop forward contracts that will withstand both regulatory review and sound business judgment. It asks for joint resolution of who should govern the ISO. It promises to sharply reduce the influence of the volatile spot market. In other words, when implemented, it will effectively cap the California wholesale market in a more defensible way than would any single state-wide or regional rate ceiling. These mechanisms will move the price of most baseload power back toward cost, while also keeping the lights on.

It is my opinion that the general level of vituperation and lack of constructive discourse among public policymakers is delaying development and implementation of a comprehensive work-out plan for California. It is difficult to overestimate the level of anger and anxiety about electric prices in California. But, this crisis cannot be simply explained or understood as the product of ideology run amok or villainy. The Commission recognizes the leverage that scarcity gives sellers of electricity and the potential for strategic manipulation of the market; it needs to develop better ways to investigate and act on abuses of market power. However, no amount of enforcement activity or legislation or litigation alone will soon alleviate the problems faced in this market. Without collaboration and negotiation between market participants and state and federal policymakers, we will continue to waste money and time. This Commission has no intention of abandoning California to its current misfortunes or letting an unsupervised market sort all this out in the fullness of time. There are real answers at hand, many in the December 15 Order, if state and market participants embrace a strategy for implementing them. For that reason, I have offered to participate in further discussions as indicated below.

The first weeks of 2001 will tell the tale. Will California regulators return 25,000 MWs of in-state utility resources to native load service under cost-of-service regulation? Will they loosen the rate freeze and devise a long-term plan to flow trapped costs to ratepayers? Will they further accelerate plant siting decisions? Will they throw support behind the negotiations at the FERC that promise to move substantial power purchases into forward contract arrangements? There is a greater likelihood of rapid progress toward market stability in the more rational give-and-take of settlement negotiations and routine regulatory decisionmaking than in the heat of political discourse and press commentary. However, I do not mean to suggest that the responsibility to act is California's entirely or that this Commission's work is done. It is clear in any case that failure to devise coordinated plans for the operation of wholesale power markets in the West will only invite state legislators or referendum supporters to venture forth with a new round of grand plans that will again run afoul of the messy realities of this evolving industry.

What might a defensible work-out plan look like?

II. Work-out Plan For California

As disappointing as it may seem to some, we cannot "price cap" California out of a supply shortage; the industry cannot build its way to a better market design; the state will find it is ultimately unable to legislate its way to sustainably low rates; and generators should not expect future earnings that dramatically outdistance the industry's historical performance. Nor, in my view, should public policymakers (including those at the FERC) expect to avoid hard work or accountability by utter reliance on nascent market forces to allocate resources, especially when it puts consumers' welfare in jeopardy. A responsible course of action is to attack the current market meltdown on several fronts over a period of time -- in California's case, three to five years. I list the following categories of actions in relation to their urgency, not necessarily their importance.

A. Pricing

Consistent with the Commissioner's Order, the impacts of spot price volatility must be diminished. We have already made clear how that might be done quickly. Assuming that reliability will seldom (if ever) be sacrificed, two additional things must happen. There must be rate certainty for both consumers and load serving utilities, and that means some prospect that utilities will recover trapped purchase power costs and that ratepayers will not feel the pain all at once, as happened in San Diego. The balance between rates that reflect the costs of energy production and delivery, and thereby stimulate appropriate supply and demand responses, and rates that moderate the impacts of extreme swings in those costs is perhaps the most difficult public policy challenge.

The cost of wholesale power, which is subject to the Commission's jurisdiction, has skyrocketed as demand has outstripped state and regional power supplies; as the cost of emissions credits and natural gas has escalated; as the auction process for wholesale sales led to panic buying at extraordinary prices; and, as generators adopt arguably inappropriate bidding strategies designed to maximize their returns. The Commission has evaluated the solutions proposed to it. Reimposition of cost-based wholesale rates, notwithstanding its surface appeal, would not necessarily reduce current problems for consumers or their utility suppliers. Our November 1 proposed Order noted that "peak demand running costs can be in the range of $160 to $200/MWh for some units . . . [&] variable costs . . . can approach $500/MWh." Moreover, it is unclear that California would even allow them to be flowed through to customers under current conditions.

Price caps are also identified as a way to staunch the hemorrhaging of ratepayer dollars. The public policy reasons that militate against capping markets are well known. Price caps tend to be arbitrary and potentially confiscatory; they create uncertainty for investors, discourage entry into the market, or even drive resources elsewhere, thereby fostering future scarcity; and, they could, absent an extraordinary order under state or federal emergency powers, lead to outages. The complications that would ensue from imposition of a Western regional price cap are even greater, given the legal and operational diversity of the regional power market, and raise concerns about subsidies to California's market. Price caps are the ultimate non-market solution and could work to disincent policymakers from undertaking more important reforms.

That said, price caps can lower prices, at least temporarily. They look and feel like real consumer protection. For that reason, I could support them, but under only two distinct circumstances: (1) if they were used as a method of affording a short "time out" within which parties could negotiate better ways to make the market work for consumers, such as bilateral forward contracts, demand response programs, or equitable relief, or (2) if they were employed as "damage caps" to prevent clearly unwarranted price explosions, such as the $1000 cap used across all three northeastern ISOs. As to the first circumstance, the willingness of buyers, sellers and the CPUC to engage in serious talks is, today, still in doubt. No one to date has offered a price cap proposal in the context of a comprehensive settlement of the issues. I call upon Secretary Richardson and top economic officials to convene the California parties in an effort to map out the parameters of a comprehensive solution to the market and financial crises that afflict California. I nevertheless submit that, for such a plan to succeed, the state must be willing to help implement our December 15 Order and support longer-term reforms of the kind I outline today.

In the final analysis, prices in California will be disciplined and the credit crunch for its utilities will be eased if structural changes to the market are implemented soon and the state uses the next year or so to decide, on the basis of analysis and collaboration with us and the market participants, what kind of business and natural environment it wants and is able to sustain. Issues of retail market entry and competition, facilities siting, load growth, air quality, and regional interdependence and cooperation are part of the mix. There is no doubt in my mind that the powerful economy of the state can extricate itself from this crisis if its leaders do not jump from the frying pan into the fire by trying to reinvent the industry once again. Competition is the solution, not the problem; however, it was not well-conceived or well-executed in California and for that, we all share blame.

One serious and little-discussed structural flaw in California's power market requires attention. It is the absence of a provision for assuring adequate generating reserves in the competitive model. The state's reserve margin has vanished in the face of surging demand. The energy market in California was kept in equilibrium during implementation of AB 1890 until early last year. But because the market was designed with the price of energy too low to stimulate enough new investment and no incentives to install reserve capacity to keep supply ahead of demand, California was on a path to a crisis that some commenters now find entirely predictable. See Figure 1 below.

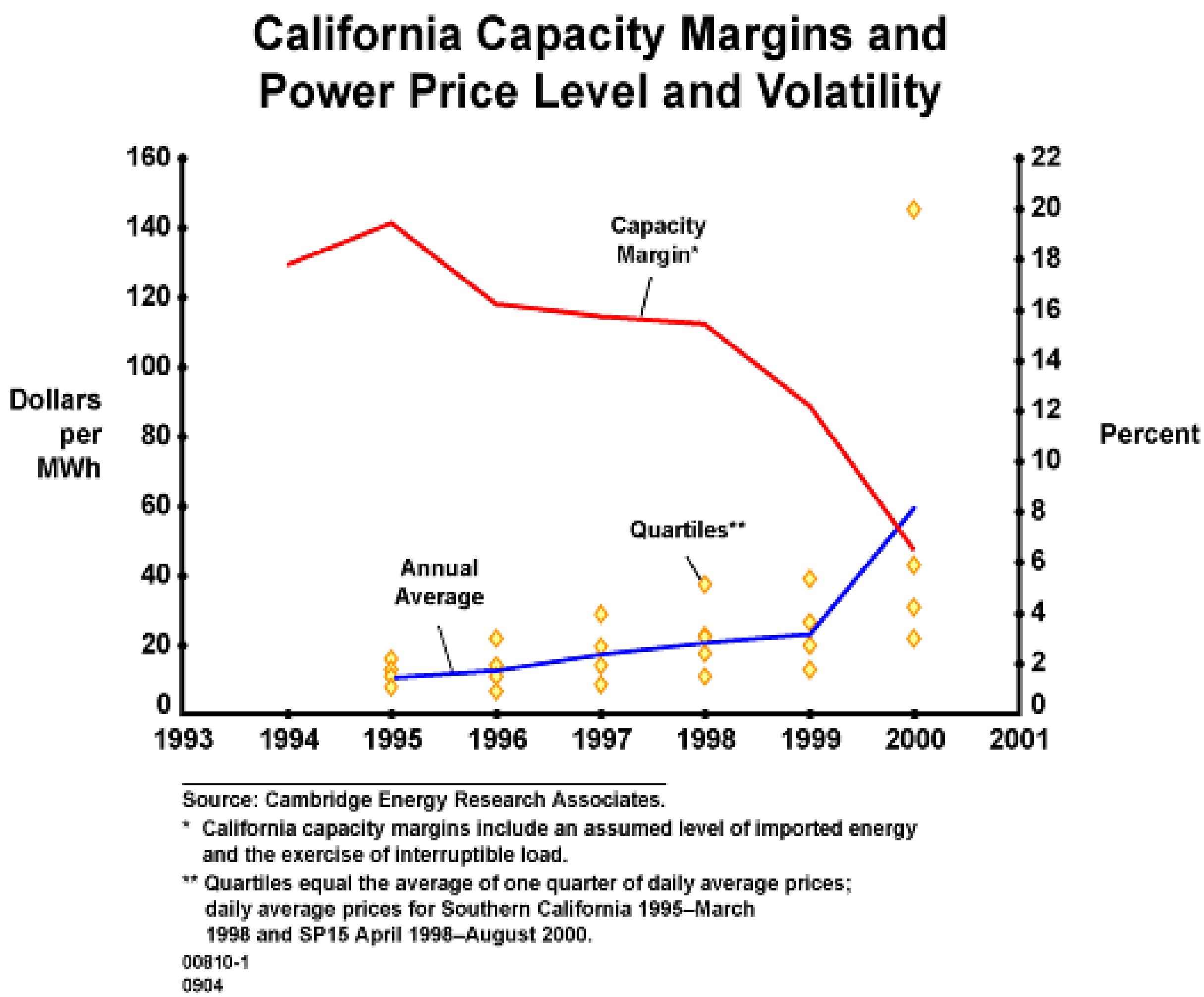

Figure 1

Other regions address this with a reserve obligation supported by a capacity market. Without it, says one analysis, "the market is designed to produce periodic reliability crises with energy price booms followed by price busts." CERA, "A Crisis By Design: California's Electric Power Crunch," September 2000, at 2. One might ascribe the stability of northeastern ISOs to their extensive past experience with reserve-sharing arrangements.

Of course, the capacity shortage is already upon California. Although a capacity market may be part of a long run solution for California, it will not fix this year's problems. In fact, a reserve requirement now could drive up prices by creating more demand for scarce supplies. But as new supplies enter the market in the future, a reserve requirement met through a capacity market could prevent the cycle from starting over with a new round of shortages and high prices in California.

How would it work? The closest counterpart to storage for a normal commodity is the extra electric power generating capacity, the so-called reserve margin. Historically, utilities tried to have about 18% - 20% more capacity than would be needed. This would account for both unexpected generation outages and unexpected demand increases, mostly weather related. Adequate generating reserves reduce the frequency and severity of price spikes, just as storage does for other commodities.

The California market should impose on load serving entities and other "customers" an obligation to build or buy sufficient capacity to serve expected requirements. This is admittedly a quasi-market approach. It does not enforce maximum efficiency out of all units. But in this highly integrated business, where the system requires everyone, and not just the visionary, to be prudent or face losing service and paying high spot prices, enforced customer-side planning ahead will be a small price to pay to avoid a cycle of boom and bust.

B. Regional Solutions Are Indispensable

California is, perhaps understandably, rife with talk of electrical secessionism. Having devised a unique but failed market structure by statute, it once again wants to go it alone in finding ways to correct what is a regional problem. Some of its leaders would stop further exports of power to other parts of the region, at least during this shortage. Even after years of relying on generators elsewhere in the region, California has developed an antipathy to out-of-state generators. A principal current policy goal appears to be to ensure that all power generated in the state is consumed there. And, it wishes any wholesale market institution like the California ISO to be "politically accountable" to the State.

Surprisingly, the importance of the Commission's Order No. 2000 to resolution of California's problem has been virtually ignored. In a region as vast and highly integrated electrically as the West, rapid development of a viable regional transmission organization will be crucial to restoring trust in the non-discriminatory operation of the grid, to effective competition for markets, to transactional liquidity and economic efficiency, and to equitable treatments for all load-serving entities in the region.

The Commission must be prepared to offer more guidance and directives on RTOs everywhere in the country now that it is clear that, with few exceptions, RTO formation is slower and more oriented to protect incumbency than we anticipated. In California and the West, however, the need for RTO development has become a matter of some urgency. And, where parties in the Pacific Northwest have assembled a workable multi-state approach, it is not clear how California fits into the regional market of the future.

There is simply no more compelling case to be made for RTOs and region-wide coordination of transmission network operations than what has happened in Western power markets in the past eight months. No one could more passionately argue for regionality in power regulation than the recent advocates of regional price caps. Clearly, this Commission has not impressed upon the West, upon California, or upon the Congress the importance of Order No. 2000. The California ISO is due to file an RTO application under that Order soon and I doubt it will find time to do so. I also doubt it is in a position to appeal to the broader Western market. Therefore, I strongly recommend that the Commission set as a goal a West-wide RTO and publish its own requirements and timetable for achieving that end, first by commanding three sub-regional RTOs: (1) to form this year in conformance with our Order and sections 205 and 206 of the Federal Power Act; and (2) to address immediately the most critical "seams" issues relating to operational compatibility, pricing, and reliability across their borders.

In addition, Western policymakers must form ranks under the still-inchoate Western Interstate Organization (WIO) or the regional regulatory organizations (RRO) I have proposed elsewhere as an effective new way to coordinate state and federal oversight of RTOs. The time has clearly come for real action under these organizations.

C. Police Work

The Commission made major strides on December 15. It needs to work with California officials and the existing ISO to reap the benefits of that Order and to devise additional measures that would be helpful. It must nevertheless re-establish its own credibility as the watchdog of this evolving and dynamic marketplace. That can be done in three ways. First, it must develop a substantial market power mitigation plan, including enhanced data collection and analysis methods. The Order makes that commitment clear. I believe the Commission must soon address two other soon-to-be critical issues, however.

To date, the Commission has not made clear how it will determine what is "just and reasonable" under the standards of the FPA in the world of market-based rates. Our Order identifies criteria that could go into that calculus. However, that level of specificity will simply be inadequate when the Commission seeks to assess the FPA Section 206 refund obligation of sellers for the period October 2, 2000 through December 2002. Unless the Commission is far more precise and public about how it will carry out its analytic tasks within its self-imposed 60 day rolling deadlines, it will either accumulate a massive and intractable workload or it will lay itself open to charges of whitewash. Moreover, the Commission could lose any deterrent effect such precision might otherwise achieve in the market.

Finally, the question lingers about the Commission's ability or willingness to act retroactively to correct alleged violations or inequities occurring last summer. Because I will likely not be at the table when the issue of retroactive refunds finally comes before the Commission, I have the following personal observations and recommendations. Much as I sympathize with the plight of San Diegans last summer, the simple truth is that the Commission would be violating the law by ordering retroactive refunds. For that reason, I would urge the Commission to map out an alternative course consistent with its enforcement responsibilities.

The analysis in our November Order did not take full account of the extensive authority granted to the Commission by Section 309 of the Federal Power Act. Section 309 explicitly authorizes the Commission to "perform any and all acts, and to prescribe, issue, make, amend, and rescind such orders, rules, and regulations as it may find necessary or appropriate to carry out the provisions of the Act." A broader delegation of authority is difficult to imagine. I believe that this authorization provides us a powerful tool to remedy unlawful market abuses or other unlawful conduct. Although it remains for our investigations to determine if that occurred in the California market, the Commission is not without remedies if it did. "Agency discretion is often at its 'zenith' when the challenged action relates to the fashioning of remedies."[1] If we find that unlawful manipulation of the market occurred, Section 309 allows us to craft whatever equitable remedies are necessary to remedy the impacts of that manipulation, including (in my view) disgorgement of unlawful or otherwise excessive gains. If, as many contend, the events of the past summer resulted from collusion, predatory pricing, or unlawful manipulation of prices in violation of FERC requirements or other provisions of law, I fully expect the Commission to employ Section 309 to do justice for San Diego. This will not be refunds but it could approximate them.

III. Conclusion

The work-out plan I have presented is likely to be more effective than revolutionary. This will be hard work.

With the benefit of hindsight, we now know that California's blueprint for competition did not create viable opportunities for the entry of new retail suppliers, did not give consumers the tools or incentives to make informed choices about electricity consumption, did not foster the siting of new generation capacity to serve the ever-growing load of a booming digital economy or new transmission needed to ensure reliability and access to reasonably priced electricity, and did not encumber the sales of generation assets with buy-back contracts to provide a ready source of reasonably priced energy for a transition period. Most importantly, we now also know that no piece of legislation can simply invent a market or erase the regionalism of the market or the mutual independence of electrical systems in the West.

Even so, California's approach worked well until last summer. Prices in wholesale markets were so much lower than the rate charged to California consumers that the California utilities were able to divert more than $11 billion towards stranded cost recovery -- enough to ensure that California utilities would incur no losses on these stranded investments. This summer, however, the California experiment imploded. A combination of factors -- extreme heat, ever-growing demand in California and neighboring states and poor hydro conditions in the Northwest -- placed a severe stress on the market design and revealed the faults: lack of new generation to meet demand, the inability of consumers to receive and respond to price increases (by either conserving, changing patterns of consumption, or switching suppliers), the failure of any new retail electricity suppliers to enter the market, a mandatory buy-sell requirement that prevented California utilities from operating those

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[1] Connecticut Valley Electric Co., Inc. v. FERC, 208 F.3d 1037, 1044 (D.C. Cir. 2000); Towns of Concord, Norwood & Wellesley v. FERC, 955 F. 2d 67, 76 (D.C. Cir. 1992).

generation resources they continue to own in a least-cost manner, severe limits on the ability of California utilities to develop a risk-minimizing power portfolio, and an inordinate reliance on volatile spot markets. As prices escalated, concern quickly turned into crisis and crisis then turned into fear and catastrophe. So where do we go from here?

Do we give up on competition and turn back the clock? A brief look should at least make us stop and think. In 1994, California electricity prices were the highest in the Nation, and there were concerns that these high rates would drive businesses out of California and worsen an already extended recession. Those high electricity prices can be traced to a series of decisions made by state-supervised monopolies, for example to pursue nuclear power plants that eventually suffered cost overruns totaling almost $10 billion and to favor alternative technologies which raised costs of power for just one California utility by $25 billion in the decade before AB 1890. During this same period, it was the interstate wholesale market that was beginning to provide substantial benefits to all Western states, including California. Seasonal exchanges between California and the Pacific Northwest created opportunities for both regions to save money and reduce the amount of needed generation capacity. Enhancements to the high-voltage transmission system allowed utilities in one state to site generation in neighboring states that were not as vulnerable to existing pollution impacts.

The past is prologue. We ought not rush to repeat its failures and some corrective options are no longer available. For example, California utilities no longer own the generation assets that would permit the state to return to "go." This Commission's answer to "Where do we go from here?" with regard to wholesale power markets is to keep moving forward, retain the workable portions of the California blueprint, and fix the broken parts with due speed. We need to work toward swift self-correction. If allowed to work, our December 15 Order will staunch the bleeding and begin a process of rehabilitation. It will contribute to price stability. It will reinforce utility creditworthiness. It will prevent a recurrence of this experience.

I believe our Order addresses the market flaws that were exposed this summer constructively and effectively. However, our solutions primarily involve market design and structure. The responsiveness of electricity demand to prices, as well as the supply picture and utility solvency, are beyond our immediate control or influence and must be worked through by state regulators or the market, or both. Our December 15 Order is very clear that this process of rehabilitation has at its core the responsible action of the California regulators and policy makers. In allowing bilateral transactions, in supporting real management of risk through forward contracts, in determining utility rates that can once again move back toward cost, CPUC action is critical. We call upon that organization to step up to its responsibilities under state law and under the new circumstances that our Order creates by reforming the FERC-jurisdictional parts of AB 1890.

These are difficult times. There are strong views on all sides about who is responsible and who did what to whom. If there are inequities and unlawful conduct, they will be discovered and remedied. However, this is not as simple as much current rhetoric might suggest. Simply put, we must all work together to forge a workable bulk power market going forward. I will opt every time for state-Federal coordination instead of gridlock, for constructive negotiations instead of hyperbole. For that reason, I remain ready, willing, and (for a time) able to meet with California officials to assemble a package of remedial measures, including those in our Order, to help the state through this crisis.

James J. Hoecker
Chairman